Gina Harrison
Director
Federal Regulatory Relations

1275 Pennsylvania Avenue, N.W., Suite 400
Washington, D.C. 20004
(202) 383-6423

PACIFIC TELESIS
Group-Washington

EX PARTE OR LATE FILED

December 13, 1996

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Federal Communications Commission
Office of Secretary

William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, N.W., Room 222
Washington, D.C. 20554

Dear Mr. Caton:

Re: Non-Accounting Safeguards, CC Docket No. 96-149;
Out-of-Region Authority, CC Docket No. 96-21

Friday, Professor Jerry A. Hausman, MacDonald Professor of Economics at the Massachusetts Institute of Technology, Michael Yourshaw and Carl Frank of Wiley, Rein and Fielding, and I met with the following to discuss issues summarized in Attachment A: Donald K. Stockdale, Jr., Deputy Chief, and Brent Olson and Craig Brown of the Policy and Program Planning Division, Common Carrier Bureau; Susan O'Connell and JoAnne Wall of the International Bureau; Elliot Maxwell, Deputy Chief, Office of Plans and Policy; Daniel Gonzalez, Legal Advisor to Commissioner Chong; and James L. Casserly, Senior Legal Advisor to Commissioner Ness. In addition, we also briefly discussed with Mr. Casserly implementation of Section 271(e)(1) of the 1996 Telecommunications Act as consistent with the Constitution. We are also attaching as Attachment B a previous ex parte filed in this docket, in response to a request from the staff.

Please associate this material with the above-referenced docket. We are submitting two copies of this notice, in accordance with Section 1.206(a)(1) of the Commission's rules. Please stamp and return the provided copy to confirm your receipt. Please contact me should you have any questions.

Sincerely yours,

Gina Harrison /mcm

Attachments

cc: C. Brown
J. Casserly
D. Gonzalez
E. Maxwell
S. O'Connell
B. Olson
D. Stockdale
J. Wall

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Non-Accounting Safeguards
Nondominant Status
International Services

Ex Parte CC Docket No. 96-21 & 96-149
December 13, 1996

PBCOM Should Be Regulated As a Nondominant Carrier

- PBCOM will have zero initial market share and no market power
  - PBCOM cannot raise prices by restricting its own output
  - PBCOM cannot raise prices by raising rivals' costs
- PBCOM cannot gain market power by cost misallocation, predation, or discrimination
- Dominant regulation will harm competition
- The U.S. Department of Justice recommends: *"The Commission should not apply its dominant carrier regulations to BOC affiliates."*

PBCOM Has No Market Power To Raise Prices by Restricting Its Own Output

- PBCOM has zero initial market share for interstate, domestic (or international) interLATA telecommunications services
  - It cannot quickly increase its market share to the point where it could raise prices by restricting output because it will be competing with large, established carriers like AT&T and MCI
- Substitutable supply capacity exists — customers can easily change providers if PBCOM's prices are not competitive
- PBCOM would not have market power under any narrower market definition

PBCOM Has No Market Power To Raise Prices by Raising Rivals' Costs

- Pacific Bell cannot exercise any "bottleneck" control
  - The Commission has determined that the Act allows competitors to provide exchange access using unbundled network elements, shattering the "bottleneck" and any competitive advantage
  - Pacific Bell must provide exactly the same treatment to CLECs that it provides to itself
- Pacific Bell's local exchange services and facilities are price controlled, precluding exercise of market power
  - Exchange access is subject to price caps
  - Unbundled elements must be priced at TELRIC

PBCOM Cannot Use Cost Misallocation, Predation, or Discrimination To Gain Market Power

- The Act's structural and accounting safeguards prevent cost misallocation and cross-subsidies
- Predation cannot be successful
  - The low marginal cost of interLATA traffic would lead to huge financial losses by a would-be predator
  - Because of the substantial sunk cost in competitors' existing networks, there is no barrier to market re-entry
- Competition cannot be distorted by discrimination
  - Discrimination cannot be effective and undetectable at the same time
  - The Act's specific nondiscrimination safeguards will be effective

Dominant Regulation Will Harm Competition

- No tariff requirement— like PBCOM's competitors
- No cost support — like PBCOM's competitors
- No 214 approval process — like PBCOM's competitors
- No price cap regulation — like PBCOM's competitors

Tariff Requirements Will Harm Competition

- No tariff requirement— like PBCOM's competitors
  - Enables PBCOM to match price changes of its competitors over an identical time period
  - Speeds new services to customers
  - Long notice periods could harm consumers by reducing price discounts and other forms of price competition among incumbent long distance carriers

Other Elements of Dominant Regulation Will Harm Competition

- No cost support — like PBCOM's competitors
  - PBCOM will compete in markets the Commission has already declared competitive — PBCOM should not be required to disclose its costs to its competitors
- No 214 approval process — like PBCOM's competitors
  - The streamlined 214 process allows rapid introduction of new services
- No price cap regulation — like PBCOM's competitors
  - Price cap regulation of PBCOM would interfere with market pricing and result in less efficient investment and service decisions

PBCOM Must Be Regulated As a Nondominant Carrier Internationally

- PBCOM Has No Market Power To Raise Prices by Restricting Its Own Output
  - PBCOM has zero initial market share for international telecommunications services
  - The market is dominated by an "oligopoly" of the big three carriers
  - Substitutable supply capacity exists — customers can easily change providers if PBCOM's prices are not competitive
- PBCOM Has No Market Power To Raise Prices by Raising Rivals' Costs
  - Pacific Bell's local exchange services and facilities are price controlled, precluding exercise of market power
  - PBCOM will not control a bottleneck—it will be required to obtain capacity from its competitors, especially AT&T, which own the cables
- Nimble U.S. Competitors Will Increase Competition in U.S.-International Markets
  - The streamlined 214 process allows rapid introduction of new services
  - Filing tariffs on 1 day's notice enables PBCOM to match price changes of its competitors over an identical time period

Grooming* Is Lawful

- FCC has already determined that flexible accounting rate arrangements are in the public interest (Docket No. 90-337, Phase II)
- Grooming is non-discriminatory
  - Nothing would prevent any carrier from negotiating similar deals
- MCI concedes legality by arguing for "reverse grooming"
- Grooming issue should be resolved as soon as possible

* Obtaining geographically enhanced mix of international return traffic

Geographic enrichment is in the public interest

- Enhances efficiency by saving costs of unnecessary long haul transmission
- Could substantially lower prices to American consumers
- Creates an economic incentive for a LEC to charge lower prices for international calls
- Leads to greater use of the network and thus increased economic efficiency
- Accords with recent International Settlements Policy (ISP) decision objectives of "allowing U.S. carriers ... to ... reduce their call termination costs and ... provide for lower calling prices for U.S. consumers"

Terminating In-Region International Return Traffic Is Legal

- The 1996 Act permits terminating traffic in-region before grant of Section 271 approval
- No policy reason to prevent it
  - No U.S. local exchange customer chooses the carrier
  - There can be no abuse of the local exchange
- If terminating in-region were forbidden
  - No BOC could offer facilities-based services out-of-region before grant of Section 271 approval
  - Proportionate return forces a carrier to terminate such traffic by operation of law
  - This result would be contrary to the clear intent of Congress.

Summary

- PBCOM should be regulated as a nondominant carrier both domestically and internationally
- Grooming is in the public interest
- Terminating in-region international return traffic before Section 271 approval is lawful

Attachment B

PACIFIC TELESIS

October 21, 1996

Mr. William F. Caton, Acting Secretary
Federal Communications Commission
1919 M Street, N.W., Room 222
Washington, DC 20554

Re: CC Docket No. 96-149

Dear Mr. Caton:

In response to a recent request by Mr. Joseph Farrell, Chief Economist, Office of Plans and Policy, Pacific Telesis Group is providing the following additional information to supplement the record in Docket 96-149.

1. A memorandum prepared by Professor Jerry A. Hausman that addresses (1) competition in cellular, CPE, and information services markets and (2) estimates of the expected economic benefit of undiscovered cost misallocation.

2. Excerpts from Pacific Bell's agreements with Cox California Telcom, Inc. and MFS Intelenet of California, Inc., which demonstrate that such agreements effectively preclude discrimination regarding directory assistance and white pages listings.

Very truly yours,

Gina Harrison

Attachments

cc w/encl.: Joseph Farrell, Gregory Rosston, Donald K. Stockdale, Jr.

To: Dr. Joseph Farrell
From: Jerry Hausman JAH
Re: Response to Information Request
Date: October 18, 1996

At our meeting on October 4, you asked for information on two questions: (1) competition in other markets where problems of cross subsidy or discrimination might have affected competition and (2) the expected economic benefit of $1 of non-discovered cost misallocation. I provide information on both of these questions in what follows.

I. BOC Participation Has Not Adversely Affected Competition in Cellular, CPE, and Information Service Markets

A. Cellular

1. BOCs have provided cellular service since 1984. In almost every MSA, the Block B ("wireline) carrier is a BOC.[1] Thus, we have over a decade of experience. Anti-discrimination regulation has worked well in cellular telephony. BOCs compete with each other in a number of MSAs. Access to the local network and to IXCs has taken place in a non-discriminatory manner. The BOCs have not impeded competition. Indeed, cellular telephony has grown at a rate of 35%-50% per year. McCaw, which AT&T purchased in 1995, is the largest cellular company in the U.S. while GTE, another non-BOC, is the fourth largest cellular company. McCaw's and GTE's cellular operations have been extremely successful. BOCs do not hold large shares of cellular customers in their market where they are the landline network provider as well. The BOCs have not impeded competition but instead, they have enhanced competition in cellular markets.

2. The recent PCS auctions provide further market evidence of the lack of distortion to competition. Bidders in the recent PCS auctions have bid over $10 billion to buy PCS spectrum. Almost all PCS carriers will depend on BOC networks for terminations of calls. If the new PCS entrants had realistic worries about BOC discrimination given that BOCs operate cellular networks in the same geographic areas, I would have expected to see lower bids or much more PCS spectrum bought by the BOCs. No such outcome occurred. Thus, PCS bidders have revealed by their recent market behavior that they believe they can compete with BOC cellular and landline operations, despite the dependence of PCS on the use of BOC networks

B. BOC Competition in CPE Markets

3. Anti-discrimination regulation has worked well in practice in CPE markets. The BOCs have been allowed to provide CPE since the AT&T divestiture in 1984, and they also provide Centrex which is a competing product to PBXs sold by AT&T, Seimens (Rolm), Northern Telecom, NEC, and other companies. The BOCs have competed in the PBX and Centrex market, and they have provided local loops for either PBX or Centrex in a non-discriminatory manner. Almost all analysts agree that the market for PBX and Centrex is extremely competitive. Centrex has only about a 20% market share. Furthermore, most BOCs became at most small competitors in PBX sales. AT&T and Rolm sell almost all of their PBXs direct, and the BOC share of PBXs sold in their regions rarely has ever risen above 25%. Thus, rather than impeding competition,

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[1] Pacific Telesis spun off its cellular affiliate in 1995 which then became AirTouch. Thus, Pacific Telesis did not find any "advantages" it received from owning a cellular operation to be sufficient to continue to own and operate a cellular carrier. However, Pacific Telesis did buy PCS spectrum and will begin to offer PCS service within a few months.

where regulation has permitted the BOCs to compete, the result has been increased competition. Prices have not been higher nor has output been lower due to BOC participation in these markets. Indeed, economic efficiency and consumer choice have both benefitted by BOC participation.

C. BOC Provision of Information Services

4. BOCs were allowed to provide information services beginning in 1991 when the MFJ decree was modified. Opponents to BOC entry made the usual forecasts of cross subsidy and discrimination. However, the BOCs have not taken over any markets, and I am unaware of any information services market where the BOCs have above a 10% market share. Indeed, Internet growth has been phenomenal. BOCs have begun to provide Internet services, but by far the largest Internet companies are AOL, Prodigy, Compuserve, Microsoft, and other non-BOC competitors.

D. LEC Provision of Long Distance

5. GTE, and now Sprint, have provided both local exchange service and long distance service without impeding competition. GTE, which is larger than the majority of the BOCs, operated the IXC Sprint for almost 10 years without impeding competition.[2] Indeed, Sprint remained in a distant third place behind AT&T and MCI in long distance share and was unprofitable during most of the period. GTE subsequently sold Sprint to U.S. Telecom (which renamed itself as Sprint) and in 1993 Sprint was permitted by the DOJ to merge with Centel, a provider of local service in a number of geographic areas. Interestingly, economic analysis has demonstrated that Sprint's long distance share was not higher in states where it provided local exchange access than its overall market share.[3] Thus, U.S. Telecom/Sprint has not impeded competition in long distance markets where it provides local exchange service and controls a "bottleneck" for some groups of customers.

6. More recent market experience for other LECs providing long distance also demonstrates the lack of competitive problems. SNET, the LEC for Connecticut, has been a successful competitor in long distance in Connecticut with no claims of discrimination against its IXC competitors. SNET, Southern New England Telephone Company, was part of the old AT&T system, but because of a historical quirk SNET, was not covered by the MFJ. SNET provides local telephone service to all of Connecticut (except for Greenwich). Thus, SNET is in a similar position to a BOC as a provider of state wide local service. SNET has been allowed to provide interLATA long distance service, and has offered attractive price plans. SNET is reported to have gained about a 25% share of long distance business in Connecticut. AT&T has petitioned the FCC (AT&T Petition, "Implementation of Section 254 (g)", September 16, 1996) to be allowed to lower its prices in Connecticut to meet the competition from SNET.

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[2] While some analysts claim that GTE is different than the BOCs because it is more dispersed geographically, GTE has high geographic concentration in Hawaii (the entire state) and in California where it serves about 20% of all telephone customers.

[3] I conducted this economic analysis during my analysis of the proposed merger.

II. Calculation of Benefit from a Hypothetical $1 of Cost Misallocation

You stated at the meeting that "pure" price caps would not allow for potential cost misallocation problems, but because of sharing and possible changes in the future in the productivity factor, that a cost misallocation could have some effect on prices. I consider each of those possibilities.

A. Productivity Factor

I hypothetically assume that a BOC can misallocate $1 from a non-regulated business to its regulated business. Of course, if the misallocation is discovered, it will be disallowed and the BOC can be fined which creates the cost of attempted misallocation. The potential benefit is that the productivity factor might be lower at the next review which I will assume will be five years in the future. Currently, the productivity factor covers a number of years, and USTA has recommended a five year average. Thus, I will use five years in my example. Suppose that the BOC succeeds in affecting the productivity factor. The BOC will only be about 11% (Pacific's amount) in the overall nationwide calculation of productivity. Thus, the $1 becomes $0.11. Now under separations the $0.11 becomes $0.11*0.20=$.022. Even if interstate access prices were to increase by this amount, the BOC would need to account for the derived demand elasticity of long distance access which is about 0.25. Thus, the increase in revenue would be $.022*0.75=$.0165. If I discount this amount over a 5 year period using a 12% discount rate, I calculate $0.0094.[4] If any reasonable amount of uncertainty is included for whether the price cap would be modified at all, I would get considerably less than a penny on one dollar of cost misallocation. Given the penalties for violating the regulations, this extremely small possible benefit demonstrates that attempts at cost misallocation would not be worthwhile.

B. Sharing

Pacific has not chosen the sharing option offered by the FCC since 1995. Indeed, Pacific has never chosen the sharing offer from the FCC since the beginning of price caps when a no sharing option was offered. No BOC currently has the sharing option with the FCC, except for US West. Of course, the FCC could always remove the sharing option if it believed that an anti-competitive problem could arise. My understanding is that since 1989 when price caps began in California, Pacific Bell has never reached the sharing level. Thus, in California, no effect would arise from $1 of misallocated costs, based on Pacific Bell's experience to date. Under the previous FCC rules, I understand that Pacific shared in 3 years out of 6. Beginning with the hypothetical $1, with sharing it would become $0.50 and with the probability of sharing it becomes $0.25. Then using the separations factor of 0.2, I calculate $0.05. Multiplying this amount by the derived demand elasticity for access lead to an estimate of $0.0375 for a $1 misallocation.[5] Any reasonable discount factor would probably decrease this amount by 50%. Once again the possible benefit from misallocation are very small, compared to the potential costs of being detected. Since the tradeoff offered by the FCC is a 0.6% lower productivity factor with sharing, yet all the BOCs (except for US West) have chosen not to share, the BOCs have demonstrated that they do not believe that misallocation to any significant degree which affects prices is a reasonable possibility. Otherwise, the BOCs would have chosen to share because it would allow them to earn higher profits.

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[4] The actual discount rate should probably be considerably higher given inherent uncertainties about possible penalties.

[5] This estimate captures the essence of the effect of sharing, but it does not purport to analyze all factors that affected real world decisions, such as the change in the earnings cap effective in mid-1995.

C. Effect on Consumers from Not Permitting BOC Entry into IntraLATA

For a valid economic analysis, we must compare the possible losses to consumers if BOCs are not permitted to compete to provide interLATA long distance to losses which could arise from possible misallocations. I now calculate the consumer harm if long distance prices are $.01 per minute higher if BOCs are not allowed to compete. I do the calculation only for residential consumers, without taking business traffic into account. I estimate the overall residential market to be about $34 billion per year in 1995. According to my random sample of customer bills the average residential price per minute was about $0.17 per minute. If instead the average price had been $0.16 per minute, the consumer welfare gain to residential consumers would be would be about $2 billion per year.[6] In California the consumer welfare gain would exceed $240 million per year. This amount far exceeds any possible misallocation. For instance, using the calculations above Pacific would need to be able misallocate costs of over $6 billion per year before the consumer harm would be approximately equal to the consumer harm from keeping Pacific out of long distance. This amount is well beyond any conceivable amount of undetectable misallocation.

[6] Note that the $0.01 decrease in long distance prices is likely to be an underestimate of BOC entry. In Connecticut, SNET offers interLATA long distance service at a considerably greater discount. The consumer welfare calculation uses an elasticity of -0.7 which is well accepted in the literature. See e.g. W. Taylor and L. Taylor, American Economic Review, 1993.

MODIFICATION TO

PACIFIC BELL AND MFS INTELENET OF CALIFORNIA, INC

CO-CARRIER AGREEMENT

JANUARY 26, 1996

WHEREAS, on November 17, 1995, Pacific Bell (Pacific) and MFS Intelenet of California, Inc. (MFS) entered into a Co-Carrier Agreement (Agreement)for the interchange of traffic between the two companies; and

WHEREAS, the Agreement was submitted for Commission approval with the filing of Pacific's Advice Letter No. 17879 on November 20, 1995; and

WHEREAS, in Commission Resolution T-15824, dated January 17, 1996, the Commission approved Advice Letter No. 17879 and the Agreement, subject to modifications specified in Resolution T-15824; and

WHEREAS, Pacific and MFS have agreed to accept the modifications and move forward with the Agreement;

NOW, THEREFORE, in consideration of the mutual provisions contained herein, as well as the provisions contained in the original Agreement, and for other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, Pacific and MFS hereby covenant and agree to modify the Agreement as follows:

5. Pacific and MFS shall impose no per trunk monthly recurring charges for LISA and JANE trunks. However, MFS shall pay Pacific non-recurring charges for LISA trunks, and Pacific shall pay MFS non-recurring charges for JANE trunks. The non-recurring charges for LISA and JANE trunks shall be: (1) to the tandem, $530 for the first trunk and $8 each additional trunk; and (2) to the end office, $650 for the first trunk and $6 for each additional trunk. In addition, labor charges for work outside of normal day business hours or for additional testing beyond normal testing, when such work or testing is requested by either Party, shall apply to the Party requesting that the work be performed.

VII. ANCILLARY PLATFORM ARRANGEMENTS

A. E 9-1-1

1. Pacific will provide E9-1-1 service to MFS under the terms and conditions of its E9-1-1 tariff proposal in I.95-04-43 and R.95-04-044. When such tariff is approved by the Commission, to the extent it establishes lower rates and charges than those contained in this Agreement, such lower rates and charges shall apply and Pacific will credit MFS the difference between what it has paid Pacific under this agreement and what MFS would have paid Pacific under the approved tariff. This credit shall be for an amount of no more than the difference in rates and charges for three months of E-9-1-1 charges under this agreement.

2. Pacific will provide Enhanced 9-1-1 (E9-1-1) service to MFS at the following rates and charges:

Service	Non-Recurring Charge	Monthly Rate
Network		
• CAMA Trunk (Minimum of 2 trunks required)	$741 (per trunk)	$26 (per trunk) $2 per mile (per trunk)
Data Management		
• E9-1-1 Tandem Switching (per 1,000 records)		$15
• Data Management Support and storage, selective routing, and ALI retrieval (per 1,000 records)		$99
• Manual Input of MFS subscriber records (per 100 records input in a one month period)	$342	
• Error Correction of MFS subscriber records (per record)	$3.50	
• Charge for MSAG (per County/per sort)	$60	
• ACES Card Management (per card)		$6
• ACES Card replacement (lost or stolen)	$140	

3. Pacific will provide MFS with an electronic interface from which MFS may input and update subscriber records. To the extent this electronic interface is not available by February 1, 1996, Pacific will waive any charges associated with manual input of subscriber records until such time as the interface is made available.

4. Pacific and MFS will work cooperatively to arrange meetings with PSAPs to answer any technical questions the PSAPs or County coordinators may have regarding the E9-1-1 portions of this agreement.

B. Transfer of Service Announcements

When an end user customer changes from Pacific to MFS, or from MFS to Pacific, and does not retain its original telephone number, the Party formerly providing service to the end user will provide a transfer of service announcement on the abandoned telephone number. Each Party will provide this referral service consistent with its tariff. This announcement will provide details on the new number to be dialed to reach this customer.

C. Coordinated Repair Calls

MFS and Pacific will employ the following procedures for handling misdirected repair calls:

1. MFS and Pacific will educate their respective customers as to the correct telephone numbers to call in order to access their respective repair bureaus.

2. To the extent the correct provider can be determined, misdirected repair calls will be referred to the proper provider of local exchange service in a courteous manner, at no charge, and the end user will be provided the correct contact telephone number. In responding to repair calls, neither Party shall make disparaging remarks about each other, nor shall they use these repair calls as the basis for internal referrals or to solicit customers to market services. Either Party may respond with accurate information in answering customer questions.

3. MFS and Pacific will provide their respective repair contact numbers to one another on a reciprocal basis.

D. Busy Line Verification and Interrupt

1. Description

a. Each Party shall establish procedures whereby its operator bureau will coordinate with the operator bureau of the other Party in order to provide Busy Line Verification ("BLV") and Busy Line Verification and Interrupt ("BLVI") services on calls between their respective end users.

b. BLV and BLVI inquiries between operator bureaus shall be routed over the LISA and JANE trunks.

2. Compensation

Each Party shall charge the other Party for BLV and BLVI at the rates contained in Pacific's CPUC tariff 175-T.

E. Directory Assistance (DA)

1. Description

At MFS' request, Pacific will:

a. Provide to MFS over the LISA trunks unbranded directory assistance service which is comparable in every way to the directory assistance service Pacific makes available to interexchange carriers.

b. In conjunction with sub-paragraph (a) above, provide caller-optional directory assistance call completion service which is comparable in every way to the directory assistance call completion service Pacific generally makes available to its own end users, to the extent Pacific generally offers such service to its end users.